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071548Z Apr 05

UNCLAS SECTION 01 OF 03 OTTAWA 001029

SIPDIS

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USDOC FOR 4310/MAC/ONA

TREASURY FOR IMI (NAGOSKI)

E.O. 12958: N/A

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SUBJECT: MAKING THE ECONOMIC CASE FOR CANADA:  
CAN THE GOC KEEP ONTARIANS ON BOARD?

REF: (A) 04 OTTAWA 2865 (B) 04 OTTAWA 2837  
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SUMMARY/INTRODUCTION

1. (SBU) Having invested a decade of their top talent in an effort to win Quebecers to the federalist cause, the GOC's national-unity strategists now find themselves in a changed landscape. Provincial governments have grown bolder and more effective in asserting themselves on fiscal issues (ref B). Several of them - not only Quebec - now openly weigh the economic pluses and minuses of being in Canada (ref C). The richest provinces - Ontario and Alberta - do not have credible secession movements, but they potentially have many options for scaling back their engagement in federal programs. Perhaps the greatest challenge to Ottawa is Ontario's apparently declining willingness to backstop the fiscal system (ref E). Ontario simply has less to gain from Canada than it once did - or at least, Ontario governments think so. Moreover, Ontarians and Albertans increasingly perceive that bank-rolling "have-not" provinces earns no thanks for them, nor for federalism. If this is true, then "fiscal federalism" has arguably failed: indeed, it has trained provincial governments to measure Canada in terms of economic self-interest. For the GOC, making the economic case for Canada in Ontario could be even tougher and more crucial than it has been in Quebec. Increasingly, the loyalty of a majority of Liberal Members of Parliament could be compromised between federal and Ontario interests.

END SUMMARY/INTRODUCTION.

"FISCAL FEDERALISM" BENEFITED QUEBEC

2. (U) The GOC's pre-World War II nation-building efforts focused on transportation, Western settlement, and rural development. The industrial heartlands of Ontario and Quebec benefited from relatively high tariff barriers which gave them protected markets in other provinces for their manufactures and services.

3. (U) From the 1950's to the 1990's, flows of funds from the GOC to provincial governments (e.g. "Health and Social Transfers") and from richer to poorer provincial governments ("Equalization Payments") became the main expression of the economic union. Auto-manufacturing Ontario and energy-rich Alberta were the net contributors to the system.

4. (U) Meanwhile, Quebec declined relatively in economic status. While several small provinces received more in transfers on a per capita basis, Quebec's larger population made it the largest overall beneficiary of "fiscal federalism." The size of transfers to Quebec drew little criticism at first. Separatism was becoming a major political force in the mainly French-speaking province, so binding Quebecers into Canada was considered a top national priority.

FEDERAL DOLLARS BUY INFLUENCE - NOT GRATITUDE

5. (U) Historically, Canada's federal government used fiscal contributions to extend its influence into areas of provincial jurisdiction - such as transportation, education, and health care. With few exceptions (ref A), the trend was that provinces accepted federally-imposed policy standards in return for large contributions to their budgets (e.g. through the Canada Health Transfer).

16. (SBU) While at least seven of ten provinces have been net recipients of GOC-administered cash, this does little to enhance Ottawa's popularity in provincial politics. Provincial leaders reliably win votes by demonizing the GOC. Indeed, the muddying of federal and provincial jurisdictions wrought by "fiscal federalism" has made it even easier to blame provincial government problems on Ottawa, however scant the justification.

17. (SBU) In certain provinces - including Newfoundland and Quebec - deep-seated cultures of regional grievance have continued to flare, unquenched by federal dollars. Quebec separatists have consistently claimed that their province does not receive its "fair share" from the federal system, and these claims - which have little factual basis - became an important part of the economic case for sovereignty. Moreover, they are widely believed. When polled, most Quebec respondents say they think the federal government "takes more tax money from Quebecers than it gives back," which is demonstrably false. Similar doubtful conceptions exist in Newfoundland and elsewhere, along with somewhat more justifiable beliefs that these provinces' economic prospects were crippled by federal policies (for example, through the declines of shipbuilding and of the Atlantic fishery).

#### THE FISCAL STRUGGLE INTENSIFIES

18. (U) During his tenure as Prime Minister (1993-2003), and particularly after the hair's-breadth failure in 1995 of a Quebec provincial referendum on separation from Canada, Jean Chretien sought to market the virtues of federalism, as opposed to merely denouncing separation. This included an intellectual and political push on the economic policy front - showing Quebec audiences hard evidence that Canada's economic union and fiscal apparatus work for them. This effort to win the loyalty of Quebecers, and to seize the initiative in the sovereignty debate, was a top concern of some of the GOC's leading minds for most of the past decade.

19. (U) Current Prime Minister Paul Martin entered office in late 2003 intending to improve relations with provinces. This quickly led to provincial leaders' combining to press Ottawa for more generous (and less conditional) fiscal transfers (ref B), led by a new deal on health care funding (ref D). Meanwhile, individual provinces developed and pressed their arguments for specific fiscal bargains with the GOC. Two small provinces, Newfoundland and Nova Scotia, successfully renegotiated the extent to which their "equalization" payments are offset by offshore energy royalties. Emboldened, Saskatchewan and the Northwest Territories are also pushing long-standing issues related to resource revenue.

#### TIRED OF LAYING GOLDEN EGGS?

10. (SBU) Energy-rich Alberta, producing about 13 percent of Canada's GDP, has been the largest provincial contributor to Canada's federal fiscal system in both absolute and per capita terms, due mainly to oil and gas revenue and pricing. While it has not complained much (so far) about making "equalization" payments to poorer provinces, Alberta's government - the most conservative among the provinces - has clashed repeatedly with Ottawa over the conditions attached to health care funding. In the past two years, their position further strengthened by surging oil and gas prices, Albertan leaders have murmured increasingly about "charting their own fiscal course" in key areas, such as health care and taxation (ref A). While Prime Minister Martin acknowledges these issues, they do not threaten his party's political base; only two of 133 Liberal Party Members of Parliament are currently elected from Alberta.

11. (SBU) Representing 41 percent of Canada's GDP, and the overwhelming political base of the Liberal government (74 of 133 MP's), Ontario is the heartland of Canadian federalism. Historically, when fighting federalist battles in Quebec and elsewhere, GOC politicians could count on deep political and financial support from Ontarians, whose industries in turn strongly benefited from the Canadian economic union and GOC nation-building activities. But since the 1960's, mainly due to trade liberalization, these inter-provincial economic linkages have declined in importance for Canada's industrial heartland, in favor of cross-border and global markets.

12. (SBU) Ref (E) provides the background to Ontario's recent dispute with the GOC over "fiscal federalism." The majority Liberal Party government in Ontario, which faces a serious budget deficit problem, reacted negatively to

Ottawa's negotiation in early 2005 of a more generous deal on "equalization" with two small provinces, Newfoundland and Nova Scotia. Ontario leaders now argue that their province is systematically shortchanged in various fiscal programs, and that as a result, the gap between what Ontarians pay in taxes to the GOC and what they receive in return has grown from C\$2 billion to C\$23 billion over the past decade. They also note (ref E) that freer trade with the United States has shrunk the compensating benefit of having protected markets in Canada.

13. (SBU) Ontario's argument is open to debate. First, a tally of fiscal payments, even if it is complete and fair, does not count all the net benefits of the federal system (it misses not just the value of the common Canadian market to Ontario industries, but also the value of some services supplied by the GOC, such as national defense and diplomacy). Second, Ontario leaders implicitly link their budget deficits (and the GOC's surpluses) to federal-provincial fiscal arrangements. As the GOC points out, however, these are two different things; even with no change in "fiscal federalism," Ontario could address its budget challenges by raising taxes and/or cutting spending (just as Ottawa did in the mid-1990's).

14. (SBU) These federalist counter-arguments, however sound, are likely to be missed by ordinary Ontarian voters and businesspeople, who are applauding the provincial government's complaints (ref E). Ontario leaders appear set to ride this issue into the next provincial election. At any rate the GOC is not yet engaging its Ontario counterpart in this publicity struggle. On the contrary, it created a Parliamentary sub-committee to study the "fiscal imbalance," which then gave Ontario officials a platform to state their case.

COMMENT

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15. (SBU) We doubt whether the GOC could outmaneuver the Government of Ontario and "sell" Ontarians on the benefits of Canada - even if Martin's minority government survives until the next Ontario provincial election, and if its credibility in this area were not being bloodied by a major scandal over the laundering of "national unity" funds.

-- First, for the GOC's national-unity strategists, the current situation represents a new and unfamiliar battlefield: they must simultaneously persuade voters in most or all provinces (rather than just Quebec) that federalism benefits them.

-- Second, the majority of GOC Members of Parliament who represent Ontario voters will be under individual pressure to show sympathy with provincial interests, and this might cripple the government's campaign at the constituency level.

-- Third, it is clear from experience in several other provinces that provincial voters love "Ottawa-bashing" and that, even where the benefits of federalism are plain to economists, they go unappreciated by voters.

16. (SBU) With provincial priorities in the ascendant across the country, and with all provinces seemingly prepared to measure federalism in terms of their economic self-interest, it is getting easier to argue that "fiscal federalism" has failed as an instrument of national unity policy.

DICKSON